

**COMMONWEALTH OF MASSACHUSETTS
BEFORE THE
DEPARTMENT OF TELECOMMUNICATIONS AND ENERGY**

An Investigation By The Department Of) D.T.E. 04-1
Telecommunications And Energy Regarding The)
Assignment Of Interstate Pipeline Capacity Pursuant)
To Natural Gas Unbundling, D.T.E. 98-32-B (1999).)

REPLY OF ENERGY EAST SOLUTIONS, INC.
TO SECOND SET OF INFORMATION REQUESTS
OF THE DEPARTMENT OF TELECOMMUNICATIONS AND ENERGY

Pursuant to the instructions in the letter dated July 7, 2004 enclosing the Second Set of Information Requests from the Department of Telecommunications and Energy (DTE) in the above-captioned proceeding, Energy East Solutions, Inc. (EES) hereby submits its responses below.

Respectfully submitted,

Energy East Solutions, Inc.

By:

Philip M. Marston, Esq.
Their counsel

MARSTON LAW
218 N. Lee Street
Suite 300
Alexandria, VA 22314
Tel: 703-548-0154
Email: pmarston@marstonlaw.com

July 14, 2004

Q. DTE 2-1:

All parties should comment on the nature and magnitude of any potential commodity-cost implications of a shift to a path, rather than slice-of-system, approach to capacity assignment, as raised in Bay State Gas Company's Reply Comments, at p. 6.

A. DTE-2-1

The concern raised by Bay State's Reply Comments is that the price of the gas supply that is available on some paths may be more attractive than the price of gas supply available on other paths. Bay State points to the example of January of 2004 when the average price for a dekatherm of gas delivered at an Iroquois delivery point (Waddington) was said to be \$8.07 while the average price per Dth delivered at an Algonquin delivery point was said to be \$6.67. Bay State further expresses a concern that the first market entrants choosing paths made available under the path-assignment approach will tend to select the most desirable paths and that this will disadvantage subsequent market entrants as well as remaining default customers of the LDC.

Assuming that one is trying to project out a reasonable period into the future, for example three to five years, it is impossible to determine the magnitude -- or even the direction -- of the impact on LDC commodity acquisition costs without being able to predict the commodity *prices* that will prevail during that time.

Accurately predicting gas commodity prices even a few months in advance is an extremely difficult task, to say the least. Neither the gas industry, nor private nor governmental experts have shown any significant ability to accurately predict the price of gas at some supply point years in advance -- much less accurately predict the relationship of that price to other prices at other supply points.¹

¹ The Energy Information Administration has for a number of years conducted an annual evaluation of its own forecasts and has repeatedly concluded that natural gas generally has been the fuel with the "least accurate forecasts" in price, consumption and production. See e.g. Esmeralda Sanchez, "Annual Energy Outlook Forecast Evaluation", U.S. Department of Energy, Energy Information Administration (for 2002), available online at http://www.eia.doe.gov/oiaf/analysispaper/forecast_eval.html (viewed July 13, 2004) ("[n]atural gas generally has been the fuel with the least accurate forecasts in consumption, production, and prices"). For the prior year's evaluation with the identical conclusion, see Susan H. Holte, "Annual Energy Outlook Forecast Evaluation", U.S. Department of Energy, Energy Information Administration (for 2001), available online at: http://www.eia.doe.gov/oiaf/archive/analysispaper01/forecast_eval.html (viewed July 13, 2004). Similarly, the American Gas Association has noted that price predictions for natural gas are "notoriously inaccurate." See American Gas Association, "Natural Gas Supply Indicators" (August 14, 2003), available online at: <http://www.texasgas.com/Natural%20Gas%20Supply%20Indicators%20Aug%2015%202003.doc> (viewed

Thus the fact that prices at a particular supply point in the recent past have tended to be more attractive than prices at other points does not guarantee that they will continue to be more attractive in the future. The Department should proceed with great caution in assuming that commodity pricing relationships will remain unchanged over a relevant future period (e.g. 3 to 5 years).

Perhaps more significant from the market's perspective is the difference between supply points that are more liquid versus those that are illiquid. The level of liquidity at a point is a reflection of the amount of supply physically available at that point and the number of wholesalers who control the right to sell those supplies. An increase in liquidity of the market at a given point will tend to dampen volatility, other things being equal. Hence, expanding capacity assignments to previously more limited points (such as Canadian import points), may in fact enhance liquidity and dampen volatility, which should benefit the market generally.

July 13, 2004), a view generally endorsed by the Consumer Energy Council of America in its March 2001 Final Report "*Oil, Gas, or . . . ? : An Evaluation of the Economics of Fuel Switching versus Home Energy Conservation*" (March 201) ("price projections often prove to be inaccurate over the long-term").

During the 1981 to 1983 debates over natural gas pricing legislation, both government and private sector forecasts predicted that prices would rise following the January 1, 1985 partial removal of price controls and the principal debate was over the amount of the increase. In fact, however, instead of rising at all, *prices fell instead*. See e.g. comparison of predictions by DOE, EIA and the AGA to actual prices in Table I and related discussion in P. Marston, "*Models for Decision: Some Reflections on the Use of Energy Models*", (paper presented at proceedings of the IMACS Second International Symposium, Upton NY (Brookhaven National Laboratory) (26-29 August 1984), *reprinted in* Kydes and Geraghty, ed., "*Energy Markets in the Longer-Term: Planning under Uncertainty*," Elsevier Science Publishers B.V. (North - Holland) 1985) at 327-331.

Q. DTE 2-2

Please provide a discussion of other potential implications, besides commodity costs addressed in the previous Information Request, of a shift to the path-based capacity-assignment standard.

A. DTE 2-2

Assuming that the paths are appropriately defined and the crediting/surcharge mechanism appropriately structured, the principal implication of shifting to the path-based capacity assignment standard will be to simplify the administration of the upstream delivery component of the open-access system. Importantly, this change reduces *operational complexity* as well, which should bear fruit in several areas. First, and most superficially, it will simplify contract administration since it will reduce the number of transportation agreements that will need to be entered into and managed with upstream pipelines. Second, and more important, it will simplify the operations component, reducing the number of nomination that must be made, simplifying the coordination of nominations and various nomination changes and confirmations as well. This means that it will tend to reduce the number of operational mistakes or miscommunications that might otherwise occur. Finally, by allowing a supplier to focus on a smaller number of upstream systems, it allows for greater mastery of the "ins and outs" of the pipeline tariffs, the idiosyncrasies of the balancing and cash-out rules, etc. All of this translates into a reduction in risk exposure: risk of miscommunication; risk of inadequate synchronization in the monthly cycle of purchases, nomination, confirmations, flow, measurement, invoice; risk of failure to respond in a sufficiently timely fashion to Operational Flow Orders and potential penalties, etc.

The whole may be expected to translate into a modest reduction in the cost of offering retail gas services and hence help to encourage the expansion of retail choice in the Commonwealth.

Q. DTE 2-3

Discuss the question as to (i) whether a shift to the path capacity-assignment standard will ease administrative burdens of contract management and thereby increase competitiveness of marketers and (ii) assuming a fully and workably competitive Massachusetts gas market, whether the impact of path-specific commodity-cost differentials will diminish as transportation volumes increase as a percentage of LDC throughput.

A. DTE 2-3:

(i) As noted in the response to question DTE 2-2, EES believes that a shift to the path capacity assignment standard would ease the administrative burden of contract management for the reasons detailed there.

(ii) Whether the impact of commodity price differentials will increase or decrease depends largely on the future evolution of commodity prices. And yet, as noted in the answer to DTE 2-1 above, prices are very difficult to predict. Indeed, if one *knew* what gas prices would be at various points in the next three to five years, one could make a considerable fortune arbitraging the difference between those prices and current projections of those prices. Absent such fore-knowledge, however, such an effort would be simply speculation.

What can be said with confidence is that to the extent that the path approach increases retail suppliers' access to gas that is priced lower than market-average, then prices to competitive-supplied customers in the Commonwealth will tend to be *lower* than they might otherwise have been (other things being equal), and conversely that to the extent prices on those paths are higher than market-average, then prices to competitively-supplied customers will tend to be *higher* than they otherwise would have been (other things being equal). Other things, however, rarely stay equal.

Q. DTE 2-4

Assuming the Department were to adopt a standard of path-based capacity assignment, please enumerate and discuss what Terms and Conditions changes might be necessary to implement such a shift.

A. DTE 2-4:

Changes to LDC Terms and Conditions would be required to address a variety of critically important details including for example (a) how the paths are defined, (b) the details of the surcharge/crediting mechanism for below-average and above-average cost paths; (c) timing of notice, elections, contracting, and any iterative process to deal with under- or over-subscription; and (d) the details of any mechanism that the Department might adopt to address a perceived preference for paths believed to access lower-than-market average paths (as discussed in more detail in the answer to question DTE 2-5 below).

Drafting these Terms and Conditions changes will require the expertise and full input of all the relevant market participants, as well as the designated staffs of the Attorney General and the Department itself and cannot be done in the abstract.

Q. DTE 2-5

What Terms and Conditions changes might need to be implemented in order that a shift to the path capacity-assignment standard would spare firm and transportation customers of any commodity-cost subsidization?

A. DTE 2-5:

The need for a mechanism to prevent the inadvertent creation of preferential or disadvantageous access to supplies on one or more contract paths turns of course on the extent to which current price relationships among contract supply paths remain the same (or similar) in the future, which, as noted above, cannot be predicted with any high degree of confidence.

Nonetheless, to the extent the Department believes that it can (or must) make such a prediction, then from an analytic standpoint, such a mechanism can be designed by constraining either *quantity* or *time*. In other words, the Department could cap the amount of capacity assigned on what it fears may be an unduly below-market average transportation path (in effect seeking to reserve a chosen amount of that capacity for LDC system supply purchases), or it could limit the length of the assignments to that path (for example, to a single year) so that it may reevaluate the situation annually. There may be a third option that could be discussed with market participants which would involve adapting the surcharge/credit mechanism to address differentials between above-average and below average transportation costs by adding a commodity-related component during peak months. These ideas are discussed below.

Cap the transportation capacity assigned. In crafting the tariff Terms and Conditions implementing the path approach, the Department could allow an LDC to cap the amount of transportation capacity made available, essentially reserving a defined percentage of that path's capacity for system sales only.

To the extent that the Department accurately predicts the trajectories of commodity prices at the various supply points in question over the period of reservation, then such a cap will help preserve a pricing advantage for LDCs or prevent marketers from gaining that price advantage instead.

However, the Department should also be aware of the fact that to the extent its prediction of commodity prices proves inaccurate (for example, if prices of gas from the "preferred" paths in fact end up above market average), then such a reservation of capacity *could end up having the*

exact opposite effect, by effectively forcing an LDC to purchase more of its system supply at above-market average prices than might otherwise have been the case. Hence, the outcomes under this approach will vary depending on the accuracy of price projections.

Cap the term of the assignments. Since predicting commodity prices is notoriously difficult, however, the Department may prefer to simply limit the term of the path assignments to a defined period, such as one year (e.g. November through October). This approach would allow the commercial participants the ability to make their own predictions as to what they believe will happen to relative commodity prices during the assignment period and to hedge those predictions if, as, and to the extent that they believe best -- thereby integrating their supply and market planning on an annual basis. If the Department pursues this approach, it will be important to define detailed allocations and terms and conditions sufficiently in advance each year for parties to plan their operations for the coming year.

Adapt the credit/surcharge mechanism to include a commodity component. A third approach might be to modify the surcharge/crediting mechanism previously recommended for addressing transportation cost differentials to incorporate a commodity component during the winter season. In other words, the surcharge/crediting mechanism during the winter months might incorporate both a commodity component as well as a transportation cost component while using the transportation charges only during the summer months (when firm capacity typically doesn't have a great deal of value anyway). The winter months' commodity component might for example use an *Inside FERC* first-of-the-month index plus the transportation charge. To take a simplified example, assume that gas from "Path #1" lands at the citygate at \$6.00 while gas from "Path #2" lands at \$8 (with equal volume) making the average price \$7.00. A shipper that elected Path #1 capacity would receive a surcharge of \$1.00 while a shipper electing Path #2 (for the same quantity, other things being equal) would receive a credit of \$1.00.

In sum, to the extent that commodity prices are lower than market average on some paths and to the extent that those lower than market average prices persist over a relevant time period (e.g. three to five years), then the Department could limit the impact by limiting the amount of transportation capacity made available for path-based assignment on those paths.

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Person Responsible: R. Cables
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In so doing, however, the Department should recognize that a change in market conditions over time could result in reversing the price relationships among the paths, in which case the limitation on assignment would drive *up* prices to utility-supplied customers and drive down prices for others rather than the reverse (as compared to a pro rata assignment of the paths). Accordingly, the Department may wish to proceed with some caution in this area and may find that *limiting the duration* of the path assignments that it is worried about may be a preferable way of addressing its concerns as opposed to trying to outguess future commodity price movements.

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Q. DTE 2-6

Each LDC should address whether or not it releases capacity on a monthly basis or some other basis, such as the term of the underlying contract, noting the relevant provisions of the company's Terms and Conditions, and explaining any variance from those provisions.

A. DTE 2-6:

This question is directed to the LDCs.

Q. DTE 2-7

If the Department were to decline to adopt the terms and conditions changes proposed by the marketers and adopted a path approach instead of a slice-of-system approach, please address the effect on system operations and competition.

A. DTE 2-7:

Adopting the path approach in place of the slice-of-system approach will provide material benefits of reducing operational complexity even if the Department does not adopt the other operational changes recommended by the marketers.

In addition, the Department may wish to note in this context that following the suggestions made by EES in its earlier comments in this proceeding some of the LDCs (e.g. Bay State Gas) have already moved to synchronize their nomination schedule and adjust the algorithms where appropriate. This kind of cooperative approach to revisiting operational issues is extremely helpful in addressing the real-world complexities regardless of the question of shifting to a path-based assignment methodology. In this context, the Department may wish to better understand why other LDCs have not been able to follow the Bay State example.

Q. DTE 2-8

If the Department were to adopt the terms and conditions changes proposed by the marketers and maintained the slice-of-system policy, please address the effect on system operations and competition.

A. DTE 2-8:

As indicated by comments filed by EES earlier in this proceeding, the single most important change the Department could adopt to enhance market operations would be to shift from the fragmentation of capacity under the slice-of-the-system approach to a path approach. While the other changes also provide some incremental benefits, adopting those changes without addressing the core problem is not likely to make a material change in the extent of customer migration or the development of retail competition generally.